adoption of SFAS - 106. Specifically, FASB sets forth explicit guidelines on the assumptions to be used in calculating the accrued OPEB expense. Consequently, the incremental cost increase attributable to the adoption of SFAS - 106 meets the Commission's criteria for exogenous treatment.

In addition, the inherent difficulties of estimating the OPEB expense under the accrual accounting method is insufficient justification for denying exogenous cost treatment. Since the Companies have demonstrated that these costs qualify for exogenous treatment, the Commission's remaining obligation is to determine the appropriate amount of expense it should authorize to receive exogenous treatment. And, based on the Godwins study and the additional information provided in this Reply, the Companies demonstrate that the Commission should grant exogenous cost treatment for 84.8 percent of the incremental costs incurred by the Companies with the adoption of SFAS - 106. This is a conservative estimate given that the majority of the adjustment from the full 100 percent exogenous treatment of the OPEB costs is the anticipated reduction in the general economy of overall wage rates. The adjustment to wage rates, as firms substitute capital for more costly labor, will occur over time and will not be present initially when the reduced exogenous cost treatment is worked through the price cap index.

II. The Incremental Costs of Implementing SFAS - 106 Meet the Commission's Criteria for Exogenous Treatment

In its *Price Cap Orders*, the Commission established exogenous treatment for specific types of expenses which result from actions beyond the control of the LECs and which would not be reflected in the other components of the Price Cap Index (PCI). One specific type of cost change that the Commission stated it would consider for exogenous cost treatment was changes in the generally accepted accounting principles or GAAP.[10] However, in determining whether a change in GAAP qualified for exogenous cost treatment, the Commission stated that the analysis was not restricted to whether the change was outside the LECs' control but also whether the cost change would be reflected in the inflation variable of the PCI.[11]

As demonstrated in the Companies' Direct Case and again herein, the adoption of SFAS - 106 meets the criteria for exogenous treatment as outlined above. Specifically, neither the adoption of the GAAP change in SFAS - 106, nor the method of calculating the expense adjustment attributable to that change in GAAP is wholly within the Companies' control. Moreover, as established by the Godwins study, the adoption of SFAS - 106 affects the LECs to a greater extent than the rest of the business community and therefore will not be fully reflected in the inflation variable of the PCI.

The LECs compete in the labor markets with other firms for skilled employees. The Companies' total compensation package (i.e., the mix of wages and benefits) to employees has been designed to be competitive with other firms. The fact that OPEB costs affect the LECs to a greater extent than the rest of the business community is an indication that the mix of compensation offer by the Companies has been more heavily weighted on benefits as opposed to wages. Had the benefits package been lower in value, the wage levels most likely would have been greater and these greater costs would have been present in the Companies' original PCIs. Exogenous cost

---

[10] *Policy and Rules Concerning Rates for Dominant Carriers*, CC Dkt. No. 87-313, 5 FCC Rcd. 6786, 6807 (1990), *modified on recon.*, 6 FCC Rcd. 2637 (1991)(*Price Cap Orders*).

[11] 6 FCC Rcd. at 2665.

treatment for the OPEB costs now justly puts the costs of these benefits being accrued for current employees into the rates charged the current customers.

Despite the straightforward analysis set forth in the *Price Cap Orders*, AT&T, MCI and Ad Hoc argue strenuously that exogenous treatment for LECs' incremental costs of adopting SFAS - 106 does not meet the Commission's established criteria for allowing exogenous treatment. Specifically, they argue that: 1) LECs control the costs of implementing SFAS - 106 through their control over the amount of OPEBs provided to the employee;[12] 2) exogenous treatment of those costs would undermine the incentives provided in price caps by treating wage and OPEB changes differently under price caps;[13] and 3) exogenous treatment will result in double counting of the incremental costs because the Commission has considered the impact of the adoption of SFAS - 106 under its most recent prescription of the LECs' rate of return.[14] Finally, Ad Hoc also alleges that LECs must provide that the lack of exogenous cost treatment will result in confiscatory rates.[15] Each of these arguments will be addressed below.

A. <u>The Costs of Adopting SFAS - 106 is outside the Control of the LECs.</u>

FASB adopted SFAS - 106 because it concluded that its implementation would result in more useful and representationally faithful financial statements of businesses offering OPEBs. In this regard, FASB noted that financial obligations regarding OPEBs have grown enormously over the last 20 years due to, among other things, the expansion of OPEBs in labor

[12] AT&T Opposition at 16; MCI Opposition at 9-10; and Ad Hoc at 15-16.

[13] MCI Opposition at 7-8; Ad Hoc at 16-17.

[14] MCI Opposition at 11.

[15] Ad Hoc Opposition at 17.

agreements, rapidly increasing medical expenses, and the success of modern medicine in extending and improving people's lives. Consequently, FASB found that, as the prevalence and magnitude of employers' promises to provide OPEBs increased, existing financial reporting was failing to identify and to accurately measure the financial ramifications of those promises. Thus, FASB found that OPEBs constitute a form of deferred compensation and adopted the method of accrual accounting for reporting these expenses.[16] FASB had taken a similar position in concept and design in the implementation of accounting for pensions under SFAS - 87.

In order to ensure that there was accurate and consistent representation of the OPEB obligation under SFAS - 106 by the businesses subject to SFAS - 106, FASB also established explicit criteria to calculate the amount of expense attributable to the adoption of SFAS - 106.[17] Specifically, FASB required that no future changes in the OPEB plans be anticipated, unless the company has contractually agreed to plan amendments granting a different benefit level or has communicated its intent to institute a different benefit level at a specified time to the affected employees.[18] Since the Companies have not changed their current benefit plan through either contract or employee notification, the Companies must, and did, assume the continuation of its current OPEB plan.[19]

---

[16] FASB concluded that the definition of financial liability is not dependent on the legal status of an obligation. SFAS - 106 at ¶¶ 152-158.

[17] *See* SFAS - 106 Statement at ¶¶ 23-73, 109-113.

[18] *Id.* at ¶ 28.

[19] While future events such as the advent of national health care could adjust future obligations to employees, these speculations are specifically precluded in the criteria established under SFAS - 106. Moreover, the cost of national health care could easily place a heavier rather than ligher financial burden on corporations.

SFAS - 106 also requires that the costs be calculated using one actuarial cost method, *i.e.*, "a portion of the expected postretirement benefit obligation is attributed to each period of an employee's service associated with earning postretirement benefits," and that amount is accrued as service cost for that period. Moreover, SFAS - 106 requires the use of explicit assumptions including discount rates, contributory plans, and other factors, and sets forth specific criteria on how to determine those assumptions.[20] The Companies do not have the discretion to deviate from the methods prescribed by SFAS - 106 and develop their own criteria for determining the liability that must be reported on external financial reporting statements. Thus, in order to comply with SFAS - 106, the Companies are required to follow specific guidelines on the calculation of their OPEB costs. Consequently, the Companies do not have control over the amount of expense incurred pursuant to the adoption of SFAS - 106 as opponents claim.[21]

Nor are these costs similar to the depreciation expense and equal access costs opponents cite as precedent for not granting exogenous treatment. In the case of equal access, the Commission found that most end offices had been converted to equal access and therefore most of the equal access costs already

---

[20] *Id.* at ¶¶ 30-34.

[21] These requirements under SFAS - 106 also preclude the Companies from attempting to substitute the components of exogenous and endogenous compensation costs as MCI argues. MCI at 6. Specifically, MCI argues that "exogenous treatment . . .will allow carriers to offer increased OPEBs . . . and decrease other forms of compensation." MCI further argues that "[r]atepayers would pay the increased costs of these programs, while LECs could turn around and reduce or hold constant over time the wages paid to their employees, thus gaining a higher rate of return." MCI at 9. As noted above, LECs must compete in the free market place for employees with certain talents and skills. They cannot arbitrarily decide to reduce or hold wages constant and still be successful in garnering the employee mix they require.

were embedded in the initial price cap rates. Moreover, since LECs might be incurring new equal access costs every year, there might be incentive for LECs to characterize costs as equal access thereby requiring continued Commission review of those costs as exogenous.[22] With regard to depreciation, the Commission found that LECs control these costs through their decisions to deploy or retire equipment. While the Companies continue to debate this finding by the Commission, at a minimum, depreciation expense is distinguishable from the incremental costs attributable to the adoption of SFAS - 106 because depreciation rates and expenses are continually reviewed and prescribed by the Commission. On the contrary, this change in GAAP is a one-time event which will increase the incremental costs of the LECs which heretofore have not been included in the PCIs.

Furthermore, the Companies do not have unlimited control over the reduction of OPEB costs in the future as AT&T and MCI claim. AT&T and MCI imply that the day following the grant of exogenous cost treatment the Companies could substantially reduce or eliminate all OPEBs in order to gain a windfall profit. Such a scenario is absurd. The provision of OPEBs, while not a legal obligation to employees or retirees (except under certain contractual arrangements) has been provided to employees and former employees of the Companies for decades, and is considered by employees to be a form of deferred compensation. Employees, and unions in particular, will continue to fight to preserve and increase these benefits. It is highly unlikely that the Companies would be willing to put their entire work force at risk by unilaterally eliminating OPEBs.[23] In this regard, FASB has concluded that

---

[22] 6 FCC Rcd. at 2665.

[23] As noted by an article by M. Warshawsky regarding the impact of SFAS - 106, "[a]lthough some employers may view retiree health benefits as a mere

the definition of financial liability is not dependent on the legal status of an obligation, but is appropriately based on the historical and anticipated financial obligations of the Companies.

B. Exogenous Treatment of OPEB Costs will not Undermine the Policies of Price Caps.

AT&T, MCI and Ad Hoc argue that Commission authorization of exogenous treatment will undermine the policies of price caps. Ad Hoc surmises that the Companies will "gold plate" their OPEB plans since they will not have to pay for them because of exogenous treatment.[24] MCI and AT&T, on the other hand, argue that exogenous treatment will create a discrepancy between the treatment of OPEBs and the treatment of other wages. This discrepancy results in the Companies reducing wages to offset the increase in OPEB costs thereby earning a greater net income.

Despite these claims, granting exogenous treatment for the incremental OPEB costs will not undermine the incentive policies of price caps. First, as described above, in order to comply with SFAS -106, the Companies cannot suddenly create costs that do not exist, but must follow established criteria and methodology in calculating their accrued costs due to the adoption of SFAS - 106. Therefore, they will be unable to "gold plate" their OPEB plans and pass those increases on to ratepayers.

---

gratuity, subject to their unilateral decision to amend or cancel the plan benefits, legal and practical considerations may make the benefits a fairly fixed obligation. . . .[a]s a practical matter, concerns about ethics, labor relations (particularly in a unionized environment), and public relations impose constraints on the ability of employers to act unilaterally on this issue." Warshawsky and Mittelstaedt, "The Impact of Liabilities for Retiree Health Benefits on Share Prices," Division of Research and Statistics, Division of Monetary Affairs, Federal Reserve Board, Washington, D.C. April 1991.

24 Ad Hoc at 16.

Second, the Companies are not seeking a wholesale return to rate of return regulation. The Companies are seeking a *one-time* exogenous change equal to the incremental cost increases that will be incurred upon the adoption of SFAS - 106. After this one-time change the Companies will have all the same incentives under price caps. This one time change will allow the Companies to adjust their PCIs to reflect the addition of these costs. It is indisputable that the Companies will incur this additional financial liability upon the adoption of SFAS - 106, and without that change in GAAP no such costs would be recorded. The Commission has provided under price caps a special recognition that exogenous treatment under such circumstances in order to ensure fairness to the LECs. In this regard, the Commission recognized the need to balance the interests of carriers and ratepayers under price cap regulation, and that carriers could not accept all financial risks without some ability to increase their prices. In this regard, the LECs' requirement to meet or surpass a productivity adjustment that is 3.3 percent higher than the general economy already presents a considerable challenge in managing the cost of providing telephone service.

Finally, granting exogenous treatment merely gives LECs the ability to adjust their PCIs and the *opportunity* to recover these expenses. It does not guarantee recovery of them. The Companies and LECs will still be subject to market conditions in pricing their services -- a market with increasing competition.

C. The Commission Never Considered SFAS - 106 in its Prescription of <u>the Rate of Return.</u>

MCI claims that exogenous treatment of the increased OPEB expenses results in a double counting because the Commission has already considered these expenses when prescribing a rate of return. To put it simply, MCI argues that the price of each LECs' stock reflected the adoption of SFAS - 106 in early 1990 and this apparent decrease in their stock price resulted in a prescribed rate of return that was higher than it would be otherwise.

The United State Telephone Association (USTA) has provided a detailed and thorough response to this issue, which is incorporated by reference herein. As succinctly pointed out in the paper, this argument completely ignores the link between risk and return, and automatically equates a perceived change in the stock price to an increase in the cost of capital. However, as the Commission has noted, a change in the stock price may leave the stock expected rate of return unchanged if the price change was the result of higher or lower anticipated profits or growth.[25] Thus, this argument fails to demonstrate that any change in LECs' stock price was the result of the market's perception that LECs' risk increased pursuant to the anticipated adoption of SFAS - 106.

In addition, MCI's and Ad Hoc's argument ignores the fact that the Commission evaluated and prescribed the rate of return based on the LECs' stock price from January 1, 1990 through June 1990, and prescribed a new rate of return in September 1990. FASB did not release the final version of SFAS - 106 until December, 1990, several months after the Commission prescribed its rate of return.

Although MCI admits to these dates, it surmises that the market could reflect the adoption of SFAS - 106 before its formal adoption because the issue had been discussed for some time. While it is clear that the market anticipated the adoption of SFAS - 106, the literature regarding the adoption of SFAS -106 during that time makes clear that there was a lack of consensus

---

[25] USTA Response at 5.

among the analysts and investors on the anticipated *impact* of SFAS - 106 on stock prices.[26] Moreover, at the same time as MCI argues that the market reflected the adoption of SFAS - 106, the Commission left open the issue of whether it would grant exogenous treatment for these incremental costs in an order denying AT&T exogenous treatment for incremental OPEB costs because the FASB had not yet mandated the change.[27] Consequently, based on MCI's theory, the market should also have reflected the fact that carriers might receive exogenous cost treatment for these expenses.

Based on the foregoing, there is no evidence or logical support for the argument that the adoption of SFAS - 106 is reflected in the current rate of return prescription.

D. The Companies Are Not Required to Show that Their Rates Will be Confiscatory Without Exogenous Cost Treatment

Ad Hoc argues that in order to receive exogenous treatment for this change in GAAP, the Companies must show that their rates will be confiscatory without such treatment.[28] As support for its position, Ad Hoc cites a recent Commission order rejecting, for the mot part, Southwestern Bell's request for a mid-course correction for their July 1, 1990 rates.[29]

As explained below, the Commission has created no such requirement for granting exogenous cost treatment for GAAP changes. In the *Southwestern Bell* decision, the Commission considered to what extent Southwestern Bell

---

[26] *Id.* at 11-12.

[27] *American Telephone and Telegraph, Revisions to Tariff F.C.C. Nos. 1, 2, and 13*, Transmittal No. 2304, 5 FCC Rcd. 3680 at ¶4 (1990).

[28] Ad Hoc at 17.

[29] *Southwestern Bell Telephone Co.*, Transmittal No. 2051, Application for Review, 7 FCC Rcd. 2906 (1992) (*Southwestern Bell*).

had proved that its July 1, 1990 rates, which were the starting point for price cap rates, should be adjusted upward pursuant to a mid-course tariff filing. In this regard, the Commission found that Southwestern Bell's tariff filing was subject to heightened scrutiny *under rate of return regulation* as a means to avoid rate inflation on the eve of price caps.[30]

Notwithstanding its decision to reject, for the most part, Southwestern Bell's filing, the Commission also evaluated whether Southwestern Bell would have been successful in raising its rates under price caps.[31] The Commission stated that in order for Southwestern Bell to increase its rates merely because it was experiencing low earnings, it could make an extraordinary request for exogenous cost treatment, but that it must demonstrate that its rates would be confiscatory without the exogenous treatment. Thus, in this decision, the Commission considered the narrow issue of LECs' ability to seek exogenous cost treatment when their earnings are too low. The Commission did not evaluate to what extent exogenous treatment is available pursuant to cost changes resulting from a change in GAAP.

Consequently, the Commission does not require the Companies' to prove that it would have confiscatory rates in the event no exogenous treatment is authorized. Rather, as discussed above, the Companies need to show (which they have) that they have no control over the increased costs and the costs will not be reflected in the inflation adjustment to their PCIs.

---

[30] *Id.* at 2909-2910.

[31] Upon the Application For Review, the Commission did allow Southwestern Bell to adjust upward their price cap base rates by $6.87 million. *Id.* at 2910.

III. There is Sufficient Evidence Supporting the Calculation of the Incremental Costs Attributable to the Adoption of SFAS - 106.

A. The Commission Should Grant Exogenous Treatment for All Incremental Costs

AT&T and MCI claim that the Commission should only authorize exogenous cost treatment for those OPEB expenses which are funded.[32] Specifically, they argue that LECs will experience a significant increase in their revenues from which they will not have to pay any expenses.

This argument ignores the underlying reasons for the adoption of SFAS - 106 and the consequences thereof. The Companies will be recording a substantial accrued obligation reflecting a financial liability for OPEBs. The Commission should not confuse the funding issue with the liability the Companies must record on their books. In this regard, the Commission should not start to regulate the cash management of LECs. Moreover, the Commission has adopted the accrual accounting method in SFAS - 87 for pension plans and does not require prefunding for those plans. There is no sufficient reason to treat OPEB costs and plans differently.

Furthermore, the Commission has resolved this issue to the extent that it has issued Responsible Accounting Officers (RAO) Letter 20 -- Uniform Accounting For Postretirement Benefits Other Than Pensions.[33] In RAO Letter 20, the Commission requires that the interstate portion of unfunded accrued OPEB costs be deducted from the rate base. Likewise, the interstate portion of any prepaid OPEB expenses is to be added to the rate base.

---

32 AT&T at 14-16; and MCI at 30.

33 RAO Letter 20, Re: Uniform Accounting For Postretirement Benefits Other Than Pensions in Part 32, DA 92-520, 7 FCC Rcd. (released May 4, 1992) (RAO Letter 20).

The Companies agree with this proposal to reduce the rate base *only if* the Commission grants exogenous treatment for the incremental OPEB costs. Without exogenous cost treatment, LECs will not be able to adjust their PCIs to reflect these increased costs and, therefore, will be precluded from including these costs in their rates. Thus, any unfunded accrued OPEB costs deducted from the rate base will not constitute customer supplied capital, but will reflect shareholder supplied capital for which the shareholders should receive a return. However, if the Commission approves exogenous treatment for these costs, the rate base treatment outlined in RAO Letter 20 is appropriate. With exogenous cost treatment, LECs have the ability to include the increased costs in their rates. Consequently LECs should not be allowed to earn a return on the unfunded portion of these costs since any unfunded OPEB costs or prepaid OPEB expenses *could* be considered customer supplied capital.[34]

However, as previously noted, even if exogenous treatment isauthorized, market conditions will dictate the prices LECs will charge for their services, a market which may not allow price increases sufficient to recover the incremental OPEB costs. Nevertheless, a reduction in the rate base will still be required for the unfunded portion of the costs although ratepayers never supplied the capital for funding.

B. The Commission Should Authorize Exogenous Treatment Even Though OPEB Expenses are Estimated.

Ad Hoc in particular claims that the estimating of OPEB expenses is sufficiently unreliable that the Commission should not grant exogenous cost

---

[34] *See* RAO Letter 20, Re: Uniform Accounting For Postretirement Benefits Other Than Pensions in Part 32, Application For Review, filed by the Ameritech Operating Companies, dated June 3, 1992.

treatment.[35] MCI in a corollary argument suggests that, because of the uncertainty with estimating the OPEB expenses, the Commission establish a mechanism whereby LECs' OPEB expenses would be "trued up" on an annual basis.

It is indisputable that the Companies must estimate their accrued expenses for OPEB costs under SFAS - 106. Nevertheless, FASB in promulgating SFAS - 106 did not find that the estimation of those expenses would be so fraught with uncertainty as to justify not implementing the accounting change. In this regard, the FASB believed that companies should be required to reflect this financial obligation on their books. Consequently, in complying with SFAS - 106, the Companies estimated the amount of their accrued financial liability attributable to OPEB costs (based on the parameters established by FASB) and reported those costs on their books. These are the same procedures required under SFAS - 87 for estimating and booking the accrued pension liability. Apparently, these estimated OPEB expenses are sufficient to record a financial liability, but insufficient to be used as a basis to recover that liability. In this regard, rejecting exogenous cost treatment because the costs are estimates is inconsistent with the Commission's *SFAS - 106 Adoption Order* authorizing LECs to implement SFAS - 106 and requiring them to amortize their transition benefit obligation to avoid rate shock.

Furthermore, the Commission should reject the proposal to "true up" OPEB expenses on an annual basis. The Companies seek a one-time adjustment to their PCIs. While the exogenous treatment is based on

---

[35] Nor is there any validity to Ad Hoc's argument that the Companies' PCIs would be inflated due to OPEB costs that were never provided. As explicitly provided in the Direct Case, the Companies' took into account, through turnover and mortality rates, that not all current employees will receive benefits through these plans.

estimated numbers, the risk is just as likely that the costs are underestimated as they are overestimated. There is no question that medical expenses have risen dramatically in the last two decades and will continue to escalate, or that with inflation alone will result in increased costs. Providing an annual true up would impose an unreasonable burden on the LECs and the Commission to track these costs indefinitely. Such a true up mechanism also will substantially interfere with the price cap objective. The Commission would be returning to rate of return regulation by requiring annual Commission review of LEC provided cost information. Opponents have not provided any evidence to justify the Commission taking such a backward step.[36]

C. The Commission Should Not Establish the Assumptions in Estimating OPEB Costs.

AT&T recommends that the Commission establish a common set of assumptions for LECs to use in estimating their OPEB expenses. These assumptions would also be used to minimize the total OPEB liability.[37] These assumptions include, among other things, capping benefits as of January 1, 1993 levels, a discount rate of 9 percent, a health care trend rate (including inflation) of 10 percent, decreasing by 0.4 percent annually to 4 percent in 2006, and reducing the health care trend rate by 4 percent each year to eliminate double counting.

There are several flaws in AT&T's recommendations to establish a common set of assumptions for estimating OPEB costs. There are distinct and trackable differences in the trends and employee characteristics both across the

[36] In the case of SFAS - 87, which employs similar accrual methodology, the estimates are not trued up on an annual basis.

[37] AT&T Opposition at 26-29.

regions and across companies in the same region. In order to realistically estimate the OPEB obligation, each LEC needs to consider its own plan characteristics and the trends that have been established over time. It is inappropriate to combine the assumptions of several LECs, when each LEC can more appropriately reflect their actual accrued OPEB expense through their specific assumpations.

In addition, the Commission should not impose different assumptions for estimating OPEB costs on the LECs than the assumptions and parameters required by FASB in SFAS - 106. The Companies and LECs are required to estimate their accrued liability based on the criteria established by FASB after due process and unanimous approval by the Board. There is no justification for second guessing criteria for the purposes of ratemaking. If the assumptions recommended by AT&T are adopted by the Commission, the Companies will not be in compliance with SFAS - 106.

Furthermore, AT&T has not demonstrated that its assumptions are more reasonable than the ones used by the Companies. It appears that AT&T's objective in choosing the assumptions is merely to minimize the incremental cost of OPEB available for exogenous treatment. For example, a 9 percent discount rate implies an underlying general inflation rate of 4 to 5 percent. The percentage equates to an ultimate health care trend rate that is 4 percent lower than AT&T's long term inflation assumption. This is contrary to expectations and is inconsistent with experience over the past 20 years.

On the other hand, the Companies' use of the discount rate of 7.5 percent is consistent with their selection of an optimistic health care trend rate. The underlying 3 percent long term inflation rate is contained in both and offsets each other. In fact, the real return in the discount rate selected by the Companies also offsets the excess of medical costs over general inflation that is included in the medical trend completely eliminates any double counting that could exist in considering OPEBs for exogenous treatment.

Consequently, the Commission should allow the LECs to determine the assumptions for estimating their OPEB costs based on the criteria established by FASB in SFAS - 106.

D. The Godwins Study is Reliable.

In a final effort to argue against exogenous treatment for OPEB expenses, AT&T, MCI, and Ad Hoc, through the ETI study, criticize and challenge the Godwins Study. The major argument is that the Godwins Study fails to properly eliminate the double counting of OPEB costs inherent in the GNP-PI. In addition, Opponents raise several additional issues with regard to the macroeconomic model and the actuarial analysis used in the study.

Despite these challenges, the Godwins Study is reliable. In particular, Godwins reviewed the criticisms to its original study and thoroughly and completely responded. This response is incorporated herein and included as Attachment A (Godwins Study II). Godwins Study II explains that the double counting defined by AT&T and MCI is precisely the factor that the Godwins Report directly and thoroughly addressed. Godwins Study II also explains that a second argument that double counting occurs does not in fact exist, because the LECs only seek exogenous treatment for the incremental cost of implementing SFAS - 106.

Moreover, it was appropriate for the Godwins Study to form a composite LEC in order to determine the impact of SFAS - 106 on the GNP-PI. Since all LECs use a single productivity factor and a single authorized rate of return, evaluating the composite impact of SFAS - 106 on the GNP-PI for use by all

LECs is consistent with the Commission's regulatory policy.[38] In addition, the NERA Study and the Godwins Study are not inherently contradictory as MCI claims merely because they made different assumptions about whether there will be price changes in the non-telecommunications business industry with the implementation of SFAS - 106.[39] The Godwins Study assumed that non-telecommunications companies would reflect some price increase in order to achieve the most conservative estimate of the impact of SFAS - 106 on the GNP-PI. Since there will likely be little or no impact on prices in the non-telecommunications sector with the implementation of SFAS - 106, the Godwins Study overestimates the impact on GNP-PI, but it does not mean the Godwins Study is unreliable.

Finally, Godwins Study II demonstrates that its original assumptions and analysis were reasonable, justifiable and based on sound economic theory.

IV. Conclusion

In this Reply, the Companies demonstrate that the Commission should dismiss the arguments set forth in the Oppositions because they do not raise any substantive arguments against the Companies' Direct Case. Therefore,

---

[38] MCI Opposition at 27 note 33.

[39] MCI Opposition at 21-23.

the Commission should grant exogenous treatment for the incremental costs of implementing the Statement of Financial Accounting Standards - 106 (SFAS - 106).

Respectfully submitted,

By: Barbara J. Kern

Floyd S. Keene
Barbara J. Kern

Attorneys for the Ameritech Operating Companies

2000 West Ameritech Center Drive
Room 4H88
Hoffman Estates, IL 60196
(708) 248-6077

Date: July 31, 1992

CERTIFICATE OF SERVICE

I, Diana M. Lucas, do hereby certify that copies of the foregoing reply ot oppositions was sent via first class mail, postage pre-paid, to the following on this 31st day of July 1992:

By: Diana M. Lucas
Diana M. Lucas

Francine J. Berry
David P. Condit
Judy Sello
295 North Maple Avenue
Room 3244J1
Basking Ridge, New Jersey 07920
Attorneys for American Telephone and Telegraph Company

James S. Baszak
Charles C. Hunter
Gardner, Carton & Douglas
1301 K Street, NW
Ste. 900, E. Tower
Washington, DC 20005
Attorneys for AD HOC Telecommunications Users Committee

Michael F. Hydock
Senior Staff Member
1801 Pennsylvania Ave., NW
Washington, DC 20006
MCI Telecommunications Corporation

Brian R. Moir
Fisher, Wayland, Cooper & Leader
1255 23rd Street, NW, Ste. 800
Washington, DC 20037-1170
International Communications Association

Greg Vogt
Chief Tariff Division
Federal Communication Commission
1919 M Street, Room 518
Washington, DC 20554

UNITED STATES TELEPHONE ASSOCIATION

Analysis of Impact of SFAS 106 Costs on GNP-PI

Supplemental Report: Responses to Objections Raised Regarding Original Study

Godwins

July, 1992

INTRODUCTION

Earlier this year, Godwins submitted a report to the United States Telephone Association (USTA) analyzing the impact of SFAS 106 on the GNP-PI, and, in particular, the extent to which the GNP-PI will reflect the increase in costs experienced by the Price Cap LECs as a result of adopting the new accounting standard. This report was placed on the record with the FCC in Bell Atlantic's Tariff Transmittal filed on February 28, 1992 (Transmittal No. 497) and was also included in U.S.West's Tariff Transmittal filed on April 3, 1992 (Transmittal No. 246).

In their filings with the FCC, several organizations took exception to the findings of that report. In particular, AT&T, MCI and the Ad Hoc Telecommunications Users Committee raised several objections with regard to various aspects of the study. The USTA has asked Godwins to provide a detailed response to each of those objections.

The purpose of this Supplemental Report is to provide the USTA with those responses. We have organized our responses into three sections, corresponding to the three different types of objections raised.

While the objections raised were numerous, this material will demonstrate that none of the objections raised should cause the Commission to have any doubts regarding the soundness of the study, or the validity of the results.

Respectfully Submitted,

Peter J. Neuwirth, F.S.A., M.A.A.A.

Andrew B. Abel, Ph.D.

TABLE OF CONTENTS

SECTION I

RESPONSE TO OBJECTIONS REGARDING OVERALL STUDY

A. Definition of Double Count

There were two objections raised with respect to the manner in which we defined the potential sources of double counting and what sort of analysis would be required to eliminate any double counting in determining the portion of the LECs' SFAS 106 costs that should qualify for exogenous treatment.

AT&T Contention - (Pages 6 and 7) "The LEC's have failed to demonstrate that the Commission's third criteria is met. To the contrary, the LECs' requests for exogenous treatment appear to reflect certain OPEB costs that will be reflected in the GNP-PI ... The double count occurs because (i) the GNP-PI component of the PCI will increase as all firms with OPEB liabilities reflect those costs through higher prices, and (ii) the SFAS 106 accrual calculation includes the present value of future inflation. If the SFAS 106 accrual is afforded exogenous treatment, the amount of the accrual will be increased automatically in future periods due to growth in inflation expressed by the GNP-PI component of PCI.** Therefore, if inflation is included in both the exogenous cost component and GNP-PI, an LEC would be compensated twice. Although the LECs recognize this problem, no carrier has met its burden of showing that it has effectively removed this double count."

Response - AT&T's description of what it considers the source of potential double counting in the LECs' request for exogenous treatment for increased costs due to SFAS 106 demonstrates some confusion as to both the double count problem and the Godwins Report. Essentially AT&T suggests that double counting may arise from two separate sources:

(1) Increases in the PCI due to increases in the GNP-PI caused by "firms with OPEB liabilities reflect(ing) those costs through higher prices."

(2) Automatic increases in the exogenously treated portion of SFAS 106 accrual "due to growth in inflation expressed by the GNP-PI component of PCI."

The first source of potential double count, while a valid concern, is precisely the factor that the Godwins Report directly and thoroughly addresses. The first paragraph of page 1 of the Godwins Report explicitly states this as the primary objective of the study. As will be seen in the responses to specific criticisms of the Godwins Report, no respondent has raised any issue which, upon scrutiny, casts doubt on any of the basic findings of the study. Therefore, the Commission should accept the Report's conclusions that (a) this source of double count accounts for 0.7% of the increase in costs attributable to SFAS 106, (b) another 14.5% of the increase will be recovered through a reduction in the national wage rate, and (c) the remaining 84.8% of such increase in costs will remain unrecovered unless exogenous treatment is granted on this amount.

The second alleged source of double counting simply doesn't exist, and is the result of confusion over exactly what the LECs are requesting. While it is true that the SFAS 106 expense calculation includes the present value of future inflation, and that the expense calculated under SFAS 106 can be expected to increase each year at something close to the rate of inflation, SFAS 106 expense is not what the LECs are requesting exogenous treatment on. It is the increase in expense due to the SFAS 106 accounting change that should be afforded exogenous treatment. This is an absolutely critical distinction which is missed by AT&T. Retiree medical plans were sponsored by firms before and after SFAS 106 was issued. It is only the accounting for those plans that has changed, and it is the increase in costs associated with this change in accounting that must be evaluated.